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C O N F I D E N T I A L SECTION 01 OF 03 BRASILIA 001427

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STATE FOR WHA/BSC, WHA/EPSC, EEB/DAS NELSON, EEB/OMA SAKAUE
STATE ALSO FOR EEB/OMA WHITTINGTON
DEPT OF TREASURY FOR IMB/BMURDEN, WMONROE, CCARNES AND
DEPT of TREASURY ALSO FOR WHA/JHOEK
NSC FOR GTOMASULO

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REF: A. SECSTATE 114420
¶B. SAO PAULO 0548
¶C. BRASILIA 1299
¶D. SAO PAULO 0086
¶E. BRASILIA 1417
¶F. SAO PAULO 0522
¶G. SAO PAULO 0486
¶H. Erath/WHA-EEB e-mail October 28

Classified By: DCM Lisa Kubiske; Reasons 1.4 (b) and (d).

¶1. (U) The following is in response to Ref A action request for information gathering leading up to the Summit on Financial Markets and the World Economy in Washington, November 15, 2008. Post also recommends Refs B, C, E, F and G which all address Brazil's reaction and response to the U.S. financial crisis.

Key Objectives and Priorities
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¶2. (C) Brazil's objectives at the Summit on Financial Markets and the World Economy will likely include making a strong statement at the outset of the meeting (in its role as G-20 president) about the urgency of global financial reform and also encouraging reforms such as stronger financial disclosure standards, greater prudential regulation, and increased limits on "shadow banks." Indeed, President Lula has spoken of the need for a global regulatory framework. Going forward, the GOB is certain to want to ensure that the equities of emerging economies and developing countries are protected. The Lula Administration was clear in its initial statements laying the blame at the doorstep of actors within the U.S. Brazil has not yet made any specific proposals for global financial reform. However, Brazil has increasingly sought to take a leading role. Brazil has voiced its interest in leading a "regional response" and held a meeting with Mercosul-plus country officials on October 27 (Septel from Brasilia) and will host a G-20 meeting of Finance Ministers November 8-9. The Brazil-hosted December

Latin American summit is also expected to focus on the global financial crisis. President Lula has been critical of the IMF, and Brazil is unlikely to support an expanded oversight role for the IMF without further reforms and an expanded Brazilian role within the IMF. Brazil's wariness of supranational organizations in which it does not have a voice includes the Financial Stability Forum as well. Contacts at the Foreign Ministry note that they would be open to the G-20 being a decision-making group but also want to ensure global transparency. In fact the GOB has advocated outreach, but not decision making, through ECOSOC to permit multiple voices to be heard in the consensus building process.

Key Concerns: FX Shortage and Lack of Trade Finance
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¶3. (U) Brazil's immediate concern has been the shortage of foreign exchange (specifically USD) in the Brazilian market due to the foreign exchange outflows since September. These outflows have had ripple effects on the exchange rate, the stock market, and a shortage of trade financing, which is likely to be President Lula's foremost concern at the G20. Likewise, credit growth has slowed sharply, some Brazilian companies have reported losses from derivatives contracts, and some small and medium banks have suffered from the lack of external credit financing.

Impact of Financial Market Crisis on the Financial Sector
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¶4. (U) The most visible impacts have been the currency

depreciation and decline of the stock market resulting from foreign currency outflows. Brazil's main equity index has declined by 50 percent since May, reflecting the readjustment of asset prices and international investors cashing in to improve liquidity in the United States and other markets. Most analysts agree that the drop in the index does not reflect a change in the fundamentals of Brazilian companies.

¶5. (U) Brazilian Central Bank (BCB) data for October (October 1 to 21) indicate rising net foreign exchange outflows. As a whole, the foreign exchange market has had net outflows of USD 3.4 billion this month. Commercial foreign exchange transaction (i.e. trade-related) inflows were USD 1.5 billion, while non-commercial (i.e. financial) foreign exchange outflows were USD 4.9 billion. As a result of the shortage of foreign exchange, the BCB has heavily intervened in the foreign exchange market. Since September 19, the BCB has provided a total of USD 28 billion in loans, swaps, and spot market sales (USD 5.3 billion, 17.6 billion, and 4.9 billion respectively).

¶6. (U) On a small scale, some of Brazil's small and medium banks have experienced some financial stress. Economic interlocutors agreed that although the Brazilian banking system has enough liquidity without external credit lines, it is not balanced across the system. Small and medium banks are less liquid because they were more reliant on external credit lines and have a smaller deposit base upon which to draw. Relative to other emerging markets and to other countries in the region, however, Brazil's financial system is stable and healthy. According to a recent World Economic Forum report, the overall health and stability of Brazil's banking system ranks 24th out of 134 countries worldwide. Indeed, Brazil's banking system is well positioned to weather the external financial crisis. In a recent conference on Brazil's financial sector, Moody's highlighted the advantages that Brazilian banks have over other regional financial institutions, including low dependency on USD, high profitability, high capital adequacy, and comparatively fewer "skeletons in the closet." Brazilian financial institutions are relatively conservative--every major Brazilian bank has a capital base that outpaces their respective Basel ratio. (Note: See Ref

B for more on the U.S. financial crisis and the Brazilian banking system. End Note.)

¶7. (U) Local credit growth has slowed significantly. A recent survey of local banks indicates that household credit growth is expected to be between five to 15 percent next year. Through September, household credit had expanded by 34 percent, following 33 percent growth last year. BCB data for the first 10 days of October showed that overall credit concessions plunged by approximately 13 percent in comparison to the same period in September.

¶8. (U) Finally, some Brazilian companies have suffered from derivates contracts, as well as a more general lack of transparency with derivatives accounting. So far, three prominent Brazilian firms, Votorantim (manufacturing, financing, new business), Aracruz (pulp), and Sadia (meat packing), have reported losses of approximately USD 2.5 billion. Rumors continue to circulate that a large number of medium-sized firms, most of which lack USD export/revenue flows, have sizeable foreign exchange mismatches and would suffer large losses if the Brazilian currency depreciates further. The BCB has begun surveying Brazilian firms and banks to determine how large this exposure is. Brazil's securities market regulator began requiring publicly traded companies to disclose their

derivatives exposure on a quarterly basis.

Actions Taken to Address the Crisis
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¶9. (U) While Brazilians spent the last year of the worldwide financial crisis preaching the strength of the Brazilian economy, economists and government officials alike have slowly altered their rhetoric and actions. The GOB has taken several precautionary measures to increase liquidity and to permit the BCB to rescue failed banks. It has also encouraged larger financial institutions to make small loans to help shore up the more vulnerable small bank sector. In a more controversial measure, the GOB submitted legislation to allow two state-run banks to purchase stock in private banks and also suspended a federal tax on international financial transactions to stimulate investment as well as to try to stem capital flight (Ref E). The BCB has also announced that it will have USD 50 billion in derivatives to sell to the market and has held several USD auctions. Finally, the BCB has postponed planned increases to reserve requirements on leasing operations (Refs C and D) and partially lifted the reserve requirements on longer-term deposits that the BCB estimates will inject approximately USD 50 billion into the system (Ref B). The crisis has also encouraged Finance Minister Mantega and Central Bank President Meirelles to coordinate their message and appear to be publicly in agreement on the handling of the crisis, in stark contrast to past public disagreements over policy.

Current Economic Situation/Near-Term Outlook
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¶10. (SBU) Like most other countries, Brazil has been strongly affected by recent global market turmoil. Brazil's 2009 growth forecast (3.5 percent consensus) has fallen by one to 1.5 percent in recent months. Unemployment may rise as economic growth slows. The outlook for inflation, the current account, fiscal performance, and other key macroeconomic indicators remains broadly stable. Despite the short-term inflationary pressures from the deprecation of the currency, the medium and long term decline in domestic demand resulting from the worldwide credit crunch is likely to keep inflation down. The current consensus is approximately five percent for
¶2009. Analysts noted, however, that Brazil's 2009 primary surplus could fall below the 3.8 percent of GDP target if

growth next year slows to 2.5 percent or less. In consideration of these factors, Brazil's monetary policy committee (COPOM) October 29 decided to leave the benchmark rate (SELIC) at 13.75 percent, in contrast to raising the rate in previous sections in an effort to control inflation. (Brazil's inflation target is 4.5%, with a band permitted to go to 6.5%. Brazil is currently near the top of that band - making yesterday's COPOM conversation reportedly challenging in building consensus on the SELIC decision).

¶11. (U) This cable was written and coordinated by Econ Sao Paulo with input from Treasury Attache and Embassy Brasilia and represents a coordinated Mission Brazil overview in response to Ref A.
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